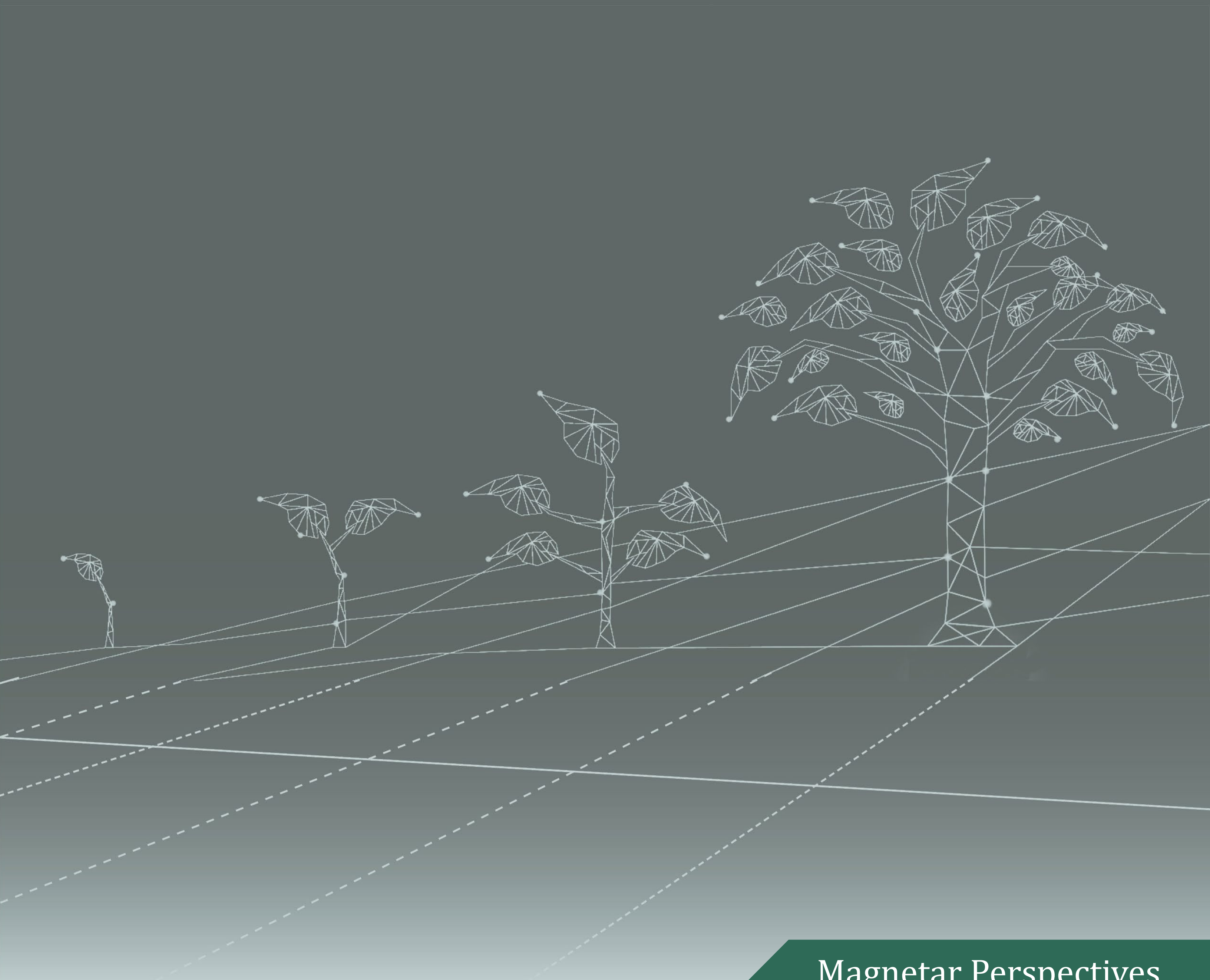

Magnetar Perspectives

SPECIALTY FINANCE: AN INVESTOR'S HISTORY

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MAGNETAR CAPITAL

ABSTRACT

In this paper, we examine the development of the U.S. specialty finance ecosystem in the modern capital markets era – from its early days when specialty lenders supported borrowers neglected by banks, to its progression as operating companies launched captive lenders, to the far-reaching implications of securitization as a new asset financing tool.

We then look at the regulatory background in which specialty finance has developed, both prior to the 2008 global financial crisis, and after.

Last, we look at the current market, summarizing the emergence of fintech platforms, and the investment case to be made for specialty finance as a compelling collateralized lending opportunity. We highlight how alternative credit ("alt credit") investors have deployed their skills and creativity in asset-based finance to capitalize the specialty finance sector's continued growth.

INTRODUCTION

As long as there have been banks, there have been disappointed borrowers.

With their fixed overhead costs, rigid business processes and extensive regulatory requirements, banks often give non-traditional or atypical borrowers the cold shoulder. These borrowers may receive a warm greeting when they visit the bank, but they will be quickly escorted out if they can't check the right boxes on the loan application. A short credit history, an unorthodox or unfamiliar line of business, or the lack of a personal guarantee all can doom the borrower's quest for a loan.

A problem for borrowers can be an opportunity for non-bank lenders, however. Through the last century of financial history, non-bank institutions have repeatedly sprung up to meet borrowers' demand for specialized capital and credit alternatives.

These institutions have a name: specialty lenders, or collectively, the specialty finance sector. The phrase "specialty finance" blends two concepts: non-bank institutions and the assets they finance.

Before the 2008 financial crisis, banks incorporated a broad array of lending businesses into their operations. After the crisis, pressure from bank regulators triggered a wholesale retreat from many of those same businesses. What had been a bank asset before 2008 became strictly a specialty finance asset after.

Thus, after 2008, specialty lenders have faced a new challenge: finding alternate sources of capital to fund assets they originate.

Another segment of the financial economy has stepped up to support these lenders and originators: alt credit investors. Dedicated to non-public market credit opportunities, alt credit investors can either inject capital directly into specialty lenders, or can serve as their financial wingmen, investing in structures that complement the lender's capital.

Specialty Finance vs. Direct Lending

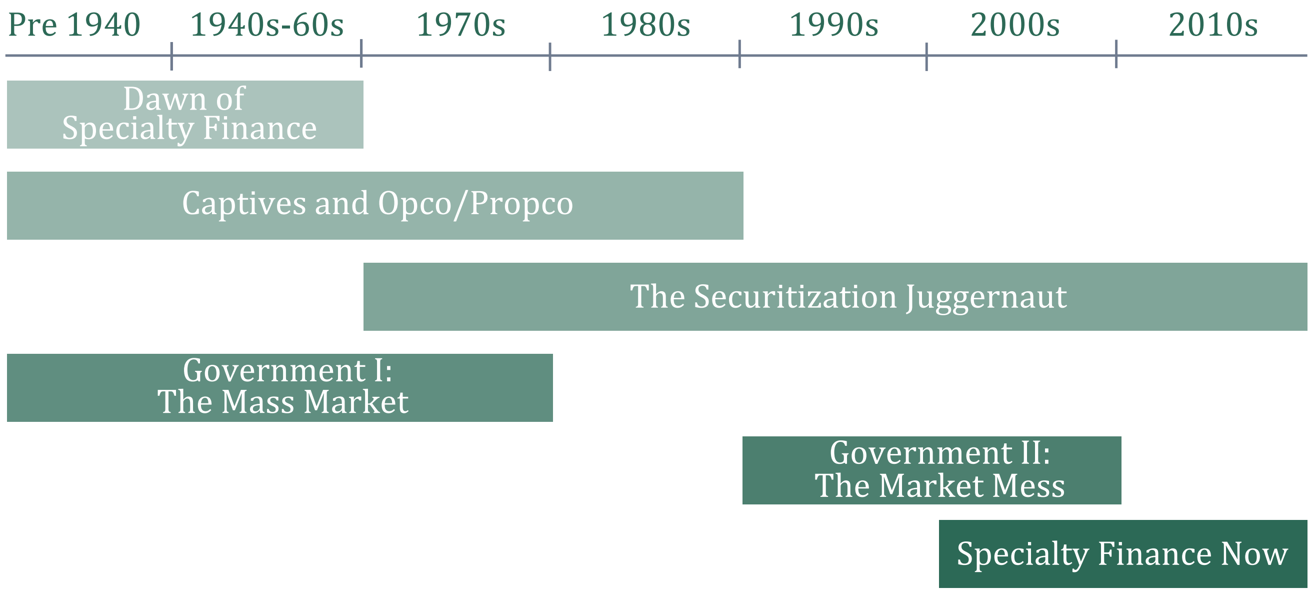
Specialty finance and direct lending – while both non-bank lending activities – are distinct concepts.

- Specialty finance involves ownership of or lending secured by financial or other hard assets, and earning an investment return tied to the assets' performance.
- Direct lending is unsecured lending to a company, relying primarily on the company's future cash flows, not on the specific collateral.

Direct lenders care about a company's overall ability to generate cash, which hinges on its strategy, management and many other factors. Specialty finance lenders instead zero in on the specific assets pledged to secure a loan.

Much of the alt credit business model boils down to classic, fundamental credit analysis—assessing the stability of the underlying asset values and cash flows. Compared to traditional credit investors, alt credit investors take a longer-term approach to investing and are willing to do the homework on investments that are complex, novel, or both. This makes them a good fit for the evolving specialty finance world, and offers them the potential to deliver higher risk-adjusted returns than those typically available in the traded debt and equity markets.

This paper will review the contemporary history of specialty finance and explain how the sector has evolved through various cycles to arrive at its current menu of investment opportunities. It will cover several overlapping themes throughout specialty finance's history:



In a companion Magnetar Perspective, Assets-as-a-Service: Credit Investors' Role in a Transforming Economy, we will more deeply examine a special case: how alt credit investors' unique capabilities have made them key players in the explosion of innovation tied to novel technologies and transformational business models.

Dawn of Specialty Finance
(Pre 1940s-1960s)

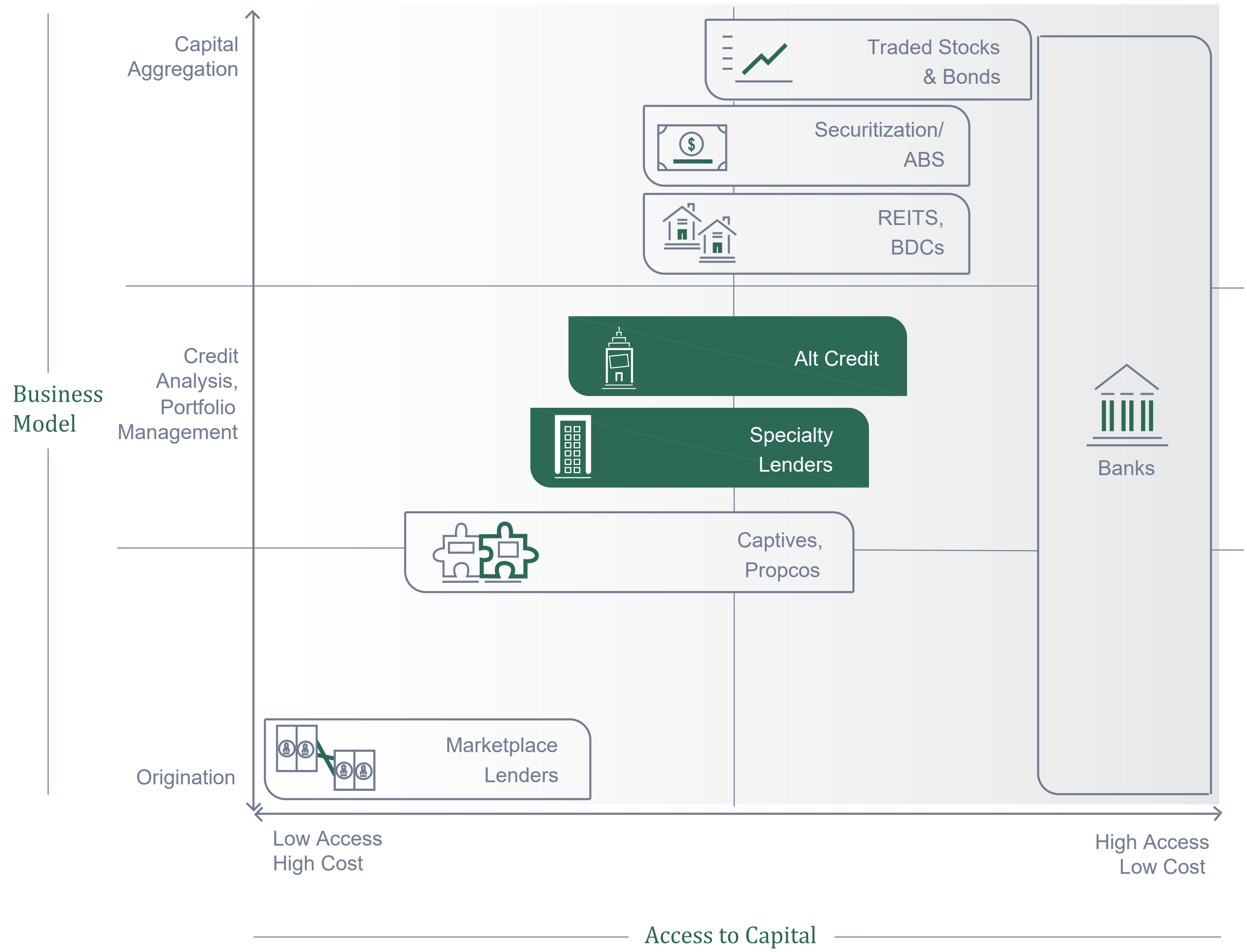
Today's specialty finance ecosystem is rich with people and organizations playing a wide variety of roles. At one end are giant financial supermarkets, banks and traditional asset managers dealing with big companies and large pools of capital. At the other end are boutiques, niche companies with bespoke financing needs.

There is also a spectrum of financial functions. At one end, lenders originate assets from businesses seeking growth capital. At the other, the capital-gathering function of banks and traditional asset managers aggregates depositor and investor capital, respectively.

In the middle sit organizations like specialty lenders and alt credit investors, whose respective origination and capital-raising functions are rooted in their expertise and underwriting skills with assets.

This ecosystem is shown in the graph on page four. The horizontal axis spans from institutions that do not specialize in accessing capital and thus bear a higher cost of capital, to those who can access capital in bulk at a low cost. The vertical axis spans from institutions that specialize in selecting assets that fit a niche to those who focus primarily on aggregating investor capital.

The Specialty Finance Ecosystem



This was not always so. When America's first consumer finance company—the Household Finance Corporation (HFC)—was founded by Frank Mackey in 1878, the ecosystem was much sparser. Capital came primarily from banks and from Wall Street's capital markets, which then catered only to big companies and the very wealthy. HFC's own evolution paralleled the development of the entire specialty finance ecosystem. HFC identified a business opportunity, scaled operations with public market capital, partnered with other institutions, and was ultimately absorbed into a bank. Understanding HFC's story helps to illuminate the factors behind specialty finance's development.

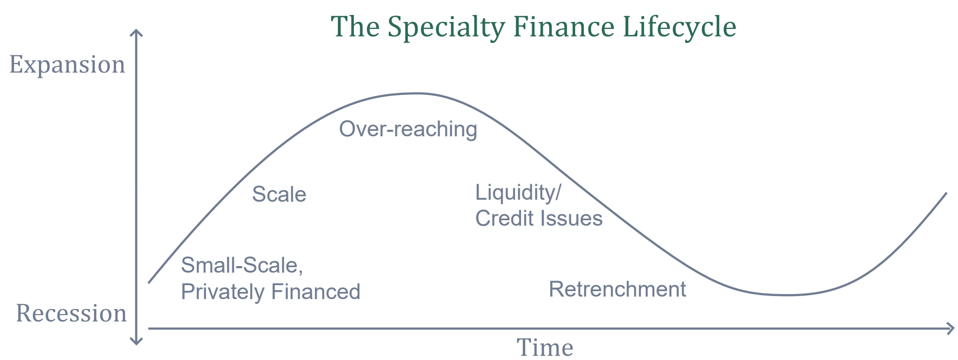
Not long after its founding, HFC pioneered several techniques that were innovative at the time. It initiated direct mail solicitations in 1896 and offered installment loans across its regional offices in 1905.

To enable capital raising, HFC incorporated issuing common equity shares on the NYSE in 1925 and then preferred equity shares three years later.

HFC went on to become one of the largest specialty finance providers in the U.S., growing organically and through acquisitions. Established bank lenders overlooked numerous sectors, giving HFC ample opportunity to scale. HFC filled these voids by creating consumer lending businesses that included real estate secured loans, auto finance loans, credit card loans, non-conforming mortgages, home equity loans, private-label credit cards, and personal non-credit card loans.

HSBC bought HFC in 2003. In its subsequent years as a unit of HSBC, HFC's business and the quality of its assets deteriorated. HSBC divested some of its HFC businesses, while integrating others into the bank's consumer lending operations.[1]

Now, the HFC brand has virtually disappeared. In retrospect, HFC's fortunes followed a classic boom-and-bust cycle, one familiar to many industries.



But the trajectory of specialty finance is not just a series of cycles. As the timeline on page three indicates, there are long-term trends at work. The specialty finance ecosystem has evolved—it has grown, provided capital to new sectors of the economy, fostered interaction among its participants and accommodated new investors. We can see this in HFC's efforts to grow. From the beginning, HFC collaborated with more-established, regulated institutions who had access to capital at a larger scale and lower cost.

Take banks. Retail depositors found security in banks' FDIC-insured deposits, providing the banks what was (effectively) very inexpensive, stable debt capital. That low-cost capital meant they could lend their cash on to specialty lenders like HFC, albeit in more conservative structures amenable to the banks' risk managers and regulators.

Traditional asset managers, like the purchasers of stocks and bonds in the public markets, also funded HFC's growth by providing debt and equity capital. Investors took comfort in the oversight of capital markets watchdogs like the Securities and Exchange Commission (SEC).

There were also partnerships on the asset side of HFC's balance sheet. From its earliest days, HFC's lending businesses collaborated with their bank counterparts. Banks spun off businesses that were bought by HFC. Ultimately, a bank—HSBC—acquired HFC.

Lastly, HFC's case exemplifies one more consequence of an integrated ecosystem: contagion. A specialty lender's cyclical excesses can spread to the banks and the public markets at the very time those bigger, more conservative institutions are under similar duress. Just ask HSBC. Looking back at losses that led up to the 2008 crisis, HSBC Chairman Stephen Green said the bank should never have acquired HFC.[2]

It is not easy for a new specialty lender to tap into the abundant capital available from regulated entities. Upstarts lending to new twentieth century businesses like automobiles or consumer credit faced particular challenges, since they did not always have the name recognition to open capital providers' doors.

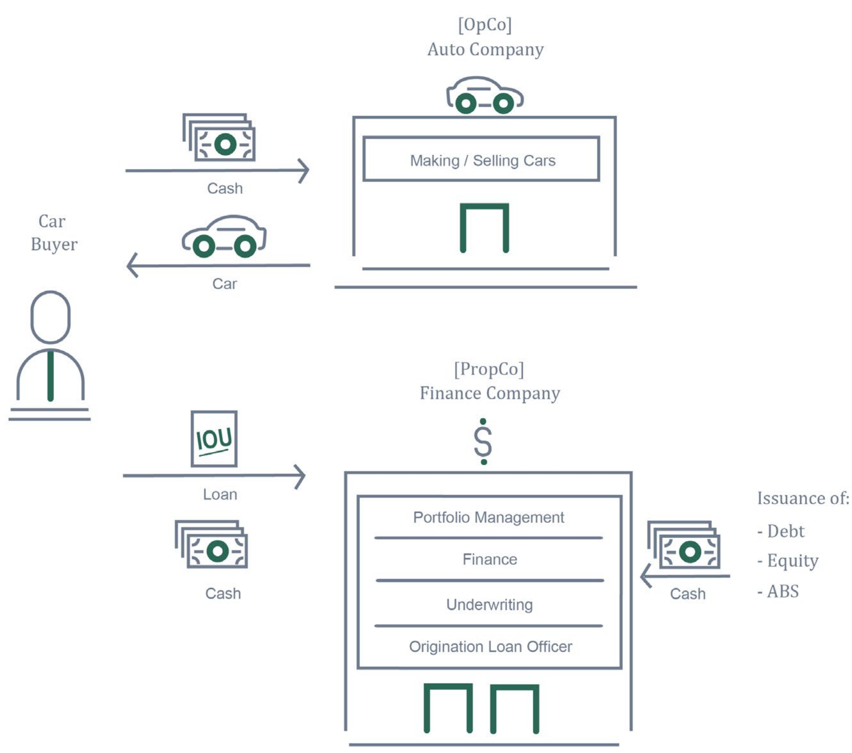
In order to increase its scale and its scope, the specialty finance sector needed an "in."

Captives and Opco/Propco
(Pre 1940s-1980s)

To facilitate a sale to a customer, industrial companies have often found that they need to provide financing. Think of the car salesperson's first question after closing the sale: "How will you be paying for that?" Many specialty lending businesses grew out of industrial companies that had become loan originators, either by design or by necessity.

For example, in the twentieth century, the U.S. "Big Three" automakers created General Motors Acceptance Corporation (GMAC), Chrysler Financial Corporation (CFC) and Ford Motor Credit Corporation (FMCC)—captive finance companies that enabled car buyers to convert a lump-sum purchase into a down-payment and monthly installments.

The unbundling of an operating company and a company that finances or owns assets as a captive partner of the operating company is often called the "OpCo/PropCo" model. The description PropCo (for "Property Company") is most often used for businesses that own real estate—the hotel business, for example.



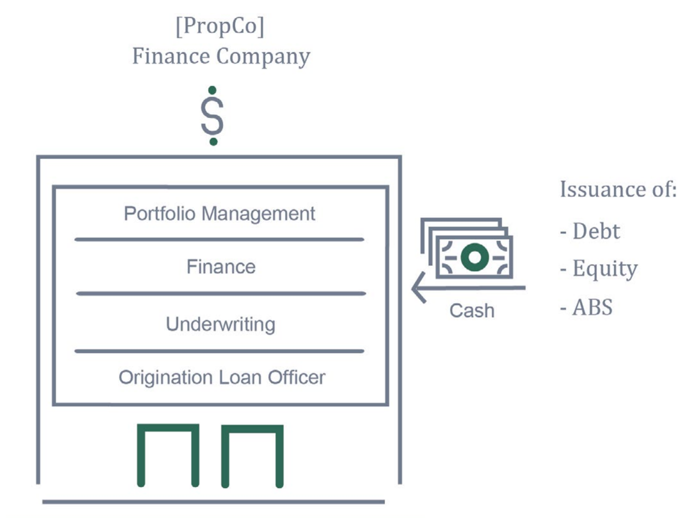
Examples have spanned many other industries, including:

1. Farm equipment, with subsidiaries like John Deere Credit and Case Credit Corp.
2. Aircraft and commercial equipment manufacturers, with the likes of General Electric Capital Corporation (GECC) and Boeing Credit.
3. Consumer credit, with retailers like Sears and Fingerhut launching credit cards.

Independent lenders also emerged, with companies like CIT, Heller Financial and Finova filling the gaps left by captive finance companies.

This development added two new layers to the ecosystem: the OpCo and, as a new breed of specialty finance company, the captive, or PropCo.

The captive or PropCo serves multiple purposes. Rather than go through life with the dual identity of a merchant and a specialty lender, the parent OpCo can break the two functions into separate entities, while preserving the cross-divisional aspects that contribute to better performance. Aided by the OpCo's deep knowledge of its home field, the PropCo has an edge in both origination and underwriting. It knows both the borrowers and the collateral. OpCos can also coordinate with the PropCo to discount product without the market seeing a reduced price. That is especially true for big-ticket purchases like planes, ships, engines and turbines. Think again of cars, with their 0% financing incentives and subsidized leasing programs.



Importantly, the OpCos have access to both debt and equity financing from the public and private markets. This gives PropCos a leg up in accessing the capital markets, either explicitly through the OpCo's financial support, through the OpCo's relationships with bankers, brokers and dealers in the capital markets, or just from the halo effect of being associated with a familiar brand name like Ford or John Deere. PropCos can tap unsecured debt markets—via bank loans, term debt and commercial paper—as well as the equity markets.

Stand-alone, unaffiliated specialty finance companies struggle to achieve that degree of capital markets access.

A PropCo's focus on financial assets and status as a frequent, high-turnover consumer of capital also incentivizes it to be aggressive and innovative in cutting borrowing costs. Its shareholders—often including the parent OpCo—win or lose based on every basis point added in asset yields or reduced in interest costs. Many of the late twentieth century's newer financial products have been actively used by the leading captive finance companies, especially when they could take advantage of their assets' value as collateral.

As specialty lending matured, the captives' vocal promotion of their parents' collateral became a learning opportunity for investors. The auto captives evangelized for the collateral quality of their cars as justification for investment-grade debt ratings and low interest costs. Investors listened, elevating the analysis of collateral to an essential part of credit due diligence.

So, it was fate. The specialty finance companies' need to sell debt and investors' need to buy paper delivering new sources of yield destined both sides to converge in what would become the booming securitization market.

I-Banks and iPads

Two important forces lurk in the background of the specialty finance ecosystem.

Investment banks have been ubiquitous in all phases of specialty finance's growth. In addition to underwriting and trading traditional capital markets products, investment banks hastened the adoption of securitization, advised on specialty lenders' growth and acquisition strategies and facilitated transactions with expanded financing desks and derivatives trading. Until the 2008 financial crisis, I-Bank proprietary traders actively capitalized the specialty lenders by providing debt and equity capital, and making strategic asset investments.

Technology has streamlined communications between dealmakers (think phones, faxes, email, mobile) and provided the tools to rapidly price and measure risk. This has enabled deals to consummate at warp speed and in previously unimagined volumes. The growth of the securitization sector has relied on spreadsheet technology that emerged in the 1980s.

As chronicled in this paper's companion piece, Assets-as-a-Service, technology is now catalyzing a re-think of every part of the capital formation process, starting with the very idea that businesses need to own assets.

The Securitization Juggernaut
(Pre 1970s-Today)

The importance of securitization may seem obvious today. In 2018, asset-backed securities (ABS) and mortgage-backed securities (MBS) accounted for $2.4 trillion in issuance, or 33% of the total U.S. bond market.[3] Early milestones arrived at a slow pace, however:

1968	1977	1985
The first guaranteed mortgage securitization occurs, sponsored by the U.S. government-backed Government National Mortgage Association, or Ginnie Mae.	The first private label mortgage securitization was done with Bank of America.	The first non-mortgage securitization, a bond deal backed by consumer auto loans, was completed by Marine Midland Bank.

Throughout the 1990s, the securitization market picked up steam. Volumes grew and asset classes expanded. Why? Because securitizations offered a competitive cost-of-capital and strategically provided lenders with a platform to build and grow businesses, and compete with larger, more established lenders. Non-prime auto lenders like ACC Consumer Finance and AmeriCredit, and non-conforming mortgage lenders like Associates First and The Money Store had more competitive costs of capital and became large players.

Securitization also increased profitability for lenders and reduced some of their exposure to volatile capital markets.

This diversification of exposure happened in multiple ways, as illustrated below.

- Organic growth into adjacent markets.
    - GMAC, the General Motors captive, expanded into commercial real estate.
    - GECC financed many consumer products.
    - Goldman Sachs built specialty lending and aircraft leasing businesses.

- Through acquisition.
    - HFC acquired ACC Consumer Finance Beneficial and others.
    - ML established ML Capital and purchased Heller Financial and others.
    - GECC acquired lenders including ML Capital.

- Lastly, banks and large finance companies provided capital to smaller finance companies. This was often through bank "special situations" investing groups which provided both collateralized loans and equity capital in a single package.

ASSET-BACKED SECURITIES: THE HOW AND WHY

What is the alchemy that makes securitization work for both investors and issuers? Ultimately, it is the same principle that can make asset-based specialty finance superior to unsecured, direct corporate lending. Good assets are often simpler to evaluate, less volatile and of a higher quality than a company's unsecured promise to repay its debt.

For the investor, ABS can deliver better risk-adjusted returns than comparable corporate debt. They also give the investor more flexibility to trade and finance the underlying assets than if those assets were buried on a corporate balance sheet. The introduction of ABS credit ratings allowed investors to streamline investment decisions by implementing ratings-based eligibility criteria.

For the issuer, the ABS can provide capital at a lower cost than an unsecured debt issuance. At the extreme, a company that is unable to tap the markets on its own can raise money using assets familiar to the market as ABS collateral. When assets are sold from the issuer's balance sheet into the issuing ABS vehicle, the issuer's unsecured credit quality may also benefit due to a reduction of balance sheet assets and an increase in cash.

Another motivation: quality.

> "In the early 1980s, there were sixty AAA-rated corporations. As of the late 2010s, there were two: Microsoft and Johnson & Johnson."

Quality has been scarce in corporate bonds, where the top-tier triple-A rating has proven to be a temporary phenomenon. In the early 1980s, there were sixty AAA-rated corporations. As of the late 2010s, there were two: Microsoft and Johnson & Johnson.[4] The rest have disappeared or been downgraded, their debt the victim of a transforming economy and the imperative to leverage up in an equity-driven environment.

For AAA-rated bonds today, investors almost always turn to the ABS market. In 2018, there were over 1,200 U.S. ABS issues, more than double the amount five years before. Virtually every one of them had a triple A-rated tranche.[5]

There have been missteps in rating ABS—the agencies made notable mistakes assigning flawed triple-As leading up to the 2008 crisis (cumulative 10-year losses on AAA residential mortgage ABS outstanding in 2008 averaged 2.3%, 400 times Moody's 10-year loss threshold for a AAA rating).[6] But securitized debt remains a major source of investment-grade debt assets in the global markets.

These many features have made the securitized products market an essential part of the specialty finance ecosystem.

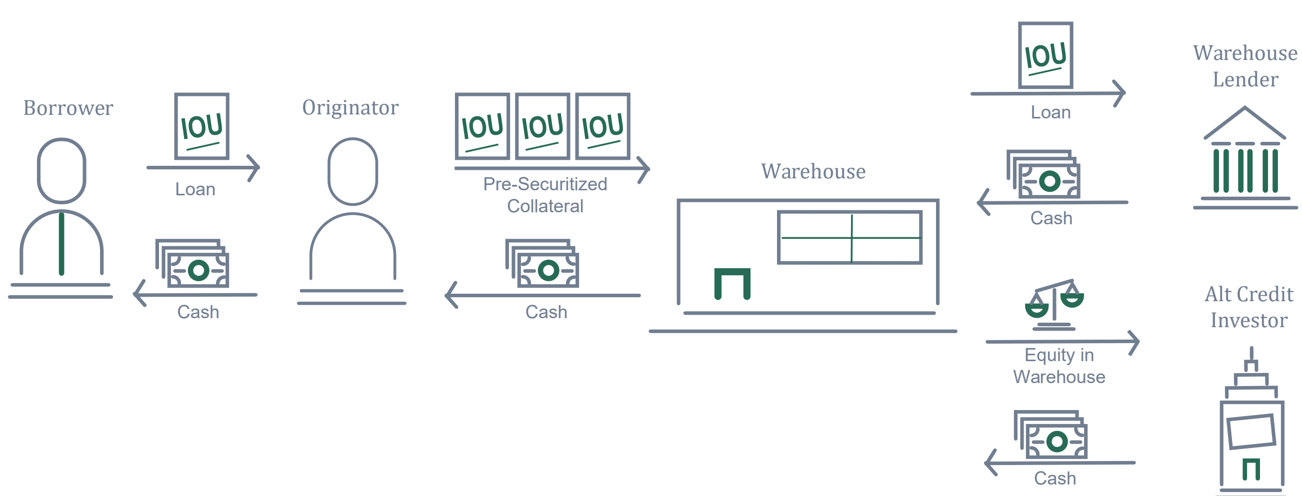
"In 2018, there were over 1,200 U.S. ABS issues, more than double the amount five years before. Virtually every one of them had a triple A-rated tranche."

MAKING AN ASSET-BACKED SECURITY

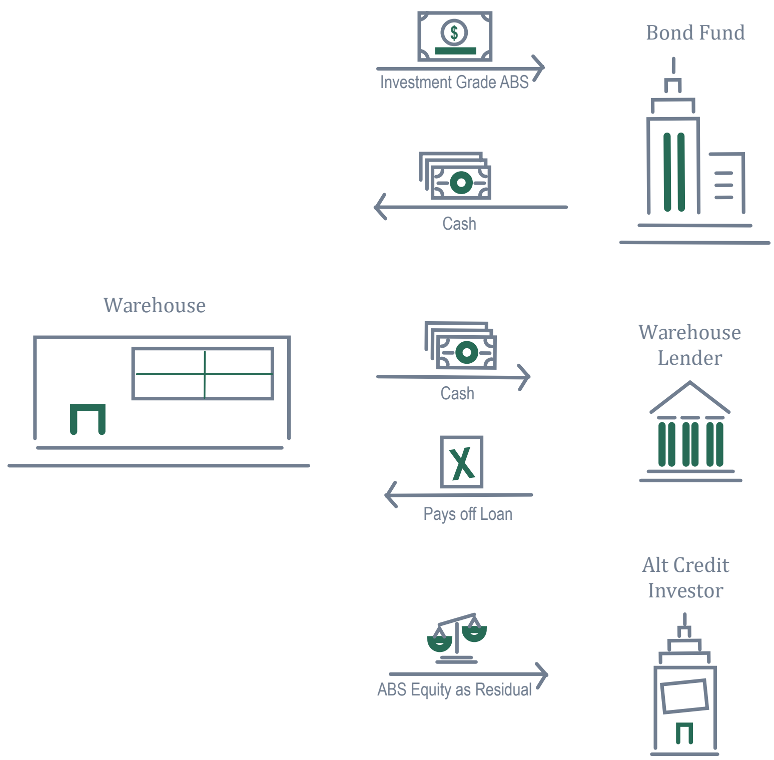
Creating an ABS is a multi-step process, and it involves a variety of players. At a minimum, there needs to be:

- An originator, who can source (and stockpile) assets.
- A pre-securitization asset warehouse (either a portfolio on an originator's balance sheet or a temporary entity, typically financed with debt and equity).
- A deal sponsor—an investment bank, originator or strategic investor—to anchor the securitization.
- Traditional investors in the senior-rated debt, once the ABS is issued.
- Alt credit investors, to acquire the unrated equity tranches of the ABS, once issued.

STEP 1: *Warehouse accumulates collateral ultimately destined to be assets in an ABS. The warehouse is funded with a combination of debt and equity, with the equity capital often coming from the bank or a third party investor and debt capital from a lender with a first lien on the collateral (often the broker/dealer underwriting the ABS).*



STEP 2: *Securitization takes place—warehouse assets are pooled. The pool is divided into tranches of liabilities, of varying ratings, with a given waterfall of payment priority. Traditional fixed income funds buy the investment-grade ABS. Proceeds pay off loan from warehouse lender. The warehouse equity becomes equity (a.k.a. residual) in the ABS deal.*



AGENCY PROBLEMS

In the above securitization diagrams, the originator, the equity investor and the ABS markets collectively are functioning like a single integrated lending institution. But there are differences. Importantly, the various players' incentives may not be aligned. As we will explore below, many believe this phenomenon helped trigger the 2008 financial crisis.

GOVERNMENT I: THE MASS MARKET
(Pre 1940s-1970s)

The government has rarely been completely blind to these agency risks, although its responses have often been backward-looking. The second half of the twentieth century was marked by a notable uptick in government activity that both democratized specialty finance and placed curbs on specialty finance activity that could de-stabilize the economy.

Modern financial regulation of banks and the securities markets began with the Federal Reserve Act in 1913. The excesses of the Roaring Twenties culminated in the Regulatory Thirties, which saw Congress pass investment laws including the Securities Act of 1933, the Exchange Act of 1934, the Investment Company Act of 1940 and the Investment Advisers Act of 1940, as well as more bank regulation in the form of the Banking Acts of 1933 (Glass-Steagall) and of 1935.

Those laws laid the foundation for the capital markets we know today, with banks, public stocks, public bonds and regulated mutual funds all offering products that provide mass access to debt and equity investments. But as the menu of specialty finance assets expanded in the institutional and private markets, regulators sought to provide public access to these emerging assets, simultaneously channeling more capital to the growing litany of businesses served by specialty finance. These efforts were reflected in several milestones that made structured vehicles available to the public:

1960	1980	1982
REITs – Real Estate Investment Trusts – were established by Congress to give all investors access to income-producing real estate.	BDCs – Business Development Companies – were created through the Small Business Investment Incentive Act of 1980 to provide financing to small, growing businesses following the 1970s' stagflation and perceived capital markets crisis. This was effectively non-bank "direct lending" accessible to all.	The Alternative Mortgage Transaction Parity Act permitted the use of variable interest rates and balloon payments, allowing the creation of more lending products.

Together, these new investment vehicles, the securitization juggernaut, and the expansion of repo financing on the large investment banks' trading desks made trading a host of structured investment vehicles very easy. This era of good feelings and ample liquidity spanned the '80s, '90s and 2000s.

Through the late nineties and into the 2000s, investment bank proprietary trading desks and the then-nascent alt credit investors were very active in specialty finance assets though both public and private securitizations. They invested in the junior parts of capital structures in many different asset classes, obtaining leverage on the underlying assets through the issuance of investment grade ABS debt. Repo leverage and the appearance of credit derivatives provided liquidity for both long and short views, as well as the ability to hedge out relatively specific unwanted risks.

Immediately preceding the 2008 financial crisis, banks controlled much of the origination and packaging of consumer and commercial assets—originating the assets, securitizing them and providing liquidity for investors to take both long and short cash and derivative positions. From 2005-2007, there was over $1 trillion of U.S. CLO/CDO issuance[7] and over $3.3 trillion of non-agency residential mortgage securitization.[8]

A few observers suggested that the newer financial products were being misused and over-engineered, harkening back to other recent crises that had called for a government response:

Early 1990s

The early 1990s Savings and Loan crisis had sunk the quasi-bank S&Ls, triggered by their own poor asset-liability management and subsequent capital flight. The government stepped in by creating the Resolution Trust Corporation (RTC) to find new homes for the assets in the alt credit, private equity and non-bank lending sectors.

1998

In 1998, a Russian default and a subsequent liquidity panic precipitated the demise of Long-Term Capital Management L.P. The Fed rounded up emergency funding from a consortium of investment banks to avert a downward spiral in asset prices.

2002

A series of corporate scandals and missteps in 2002 caused major losses in credit markets. The accounting and governance scandals at Arthur Andersen, Adelphia, Enron, and WorldCom compelled changes in accounting standards and the passage of the Sarbanes-Oxley Act.

Indeed, it was a combination of all three blunders—poor asset-liability management, excessive leverage and bad accounting and governance—that led to the 2008 financial crisis. The problems were so deep and so systemic that a government response was a necessity. While the best known government actions were the September 2008 measures taken as Lehman Brothers failed, others also had profound and long-lasting effects on specialty finance.

From the perspective of market structure, the crisis highlighted how separating the origination of an asset from its ownership can create misaligned incentives. An originator could juice its revenue by originating a lot of bad assets, sabotaging the investor's performance. Securitization made that extraordinarily easy, since a syndicated ABS could scatter an asset into the hands of literally millions of owners.

Economists call this an "agency problem" since the originator is merely an agent in the purchase of the asset, not the principal, or owner. This specific agency problem is often blamed for the failure of so many ABS during the 2008 financial crisis, arguably the first domino in the subsequent fall of so many financial institutions.

The most common ways to address this are (a) to subject the attributes of the assets moving into the investment vehicle to clear, eligibility criteria, and (b) for the originator to retain enough of an ownership (or principal) position in the assets to have a meaningful exposure to their performance. This kind of skin in the game" is now mandated by regulators for some asset classes and some institutions, usually captured in regulators' "risk retention" rules. Increasingly, investors also demand features that will align originator and owner behind a common goal of satisfactory asset quality.

> "Under the Dodd-Frank Act... banks had returned to saying 'no.'"

However, the most important and lasting post-crisis change was the retreat of banks. Under the Dodd-Frank Act of 2010, regulators forced banks to reduce risk through either explicit limits or more stringent capital requirements. Banks had returned to saying "no." That made life difficult to borrowers who had been spoiled by the open spigot of bank liquidity in the decade leading up to the crisis.

In earlier cycles, specialty lenders may have stepped in themselves. But immediately after 2008, many financial institutions were limited by the scarcity of new capital. To participate in the very high post-crisis returns available on specialty finance assets, an investor needed locked-in capital, a committed arrangement with a capital provider, a creative approach to leverage, or an ability and willingness to buy assets without leverage.

Alt credit investors met that description. The alt credit business emerged during the waves of financial crises in the 1990s, buying distressed debt, non-performing loans and other casualties of financial disarray. It had grown beyond isolated pockets of traders on certain sell-side desks, becoming an organized activity staffed by sophisticated teams with the ability to combine fundamental analysis and structuring expertise.

In the final tally, government regulation is responsible for three new sets of participants in the specialty finance ecosystem, two directly and one indirectly. The government created new retail investment vehicles—REITs and BDCs. Then, indirectly, it supported the growth of the alt credit sector, which came on the scene to accommodate the re-privatization of troubled assets.

> "The alt credit business emerged...in the 1990s, buying distressed debt, non-performing loans and other casualties of financial disarray."

SPECIALTY FINANCE NOW
(2000s-Today)

The markets today still feel the ripples of the 2008 financial crisis. Government bailout vehicles are no longer required, but with banks opting out of many asset classes, a larger and more established alt credit sector is stepping into the void. Alt credit investors are buying assets outright, or sometimes with leverage, and in many cases, providing capital to the resurgent specialty finance sector.

The distressed asset opportunity is gone with the biggest, most liquid sectors offering particularly slim pickings—in particular, sectors tied to unsecured corporate credit. Immediately after the 2008 financial crisis, liquidity did dry up in the capital markets, with trading levels looking fundamentally cheap to many alt credit investors. But a comparison of trading levels from the market trough in 2009 to 2012 reveals a decisive snap-back to more typical levels.

The S&P 500 equity index rose 76.5% from month-end March 2009 (797.87) to month-end March 2012 (1408.47). In the context of credit market movements, securitized products such as CLOs and non-agency Mortgage Backed Securities saw comparably dramatic surges in price and declines in yield.

Niches of value remain, however, even as we enter 2020. For several reasons, alt credit investors have found specialty finance to be rich with opportunities, given that specialty finance assets:

- Amortize balances...improving a loan's collateralization position over time.
- Have short durations...facilitating efficient re-deployment of capital based on opportunities.
- Enable non-recourse leverage...(often with longer tenors than the assets), locking-in liability levels and terms for a period of time if the market widens.
- Offers diverse risks...with low correlations to markets, the economy, and one another, insulating them when the markets and economy are into the late stages of a recovery.

These attributes, coupled with portfolio construction designed to exploit the diversity and the low correlation of specialty finance assets, often make the sector perform in a notably more stable, "all weather" fashion through economic and market cycles.

> "Specialty finance assets amortize, have short durations, enable non-recourse leverage and offer diverse risks."

In addition, other participants in the process can improve credit analysis since asset quality and the originator's operating skill are often linked. For alt credit investors seeking value, selecting good underwriting partners is more than half the battle.

At a more basic operational level, originators are often thought to need:

- A clear understanding of its costs of capital versus competitors.
- A willingness and ability to take additional risk.
- A regulatory regime that allows it to compete.
- Performance objectives aligned with asset quality (again, the question of agency problems).

THE TABLES TURN: BANK AS A CUSTOMER OF ALT CREDIT

Banks and alt credit investors usually operate at opposite ends of the specialty finance spectrum, with banks serving the mass-market, low-return end of the spectrum, participating only in more generic asset deals. Yet one post-2008 opportunity has brought banks and alt credit investors together in a symbiotic relationship.

In 2008-2009, both U.S. and European regulators created programs to facilitate or subsidize bank-sponsored securitizations. The twin objectives were to extricate banks from over-extended positions in specialty finance assets, and address banks' inabilities to raise equity when their stocks were trading so far below book value. Banks couldn't sell capital-intensive assets since the discount would have further strained equity ratios. Alt credit investors were eager buyers of those ABS, often benefitting from attractive leverage terms that were also offered by government programs.

> "[B]anks ... work with alt credit investors on customized securitizations designed to provide relief to the banks' capital positions."

Since then, banks have continued to work with alt credit investors on customized securitizations designed to provide relief to the banks' capital positions. In essence, the banks are sharing exposure to some of their assets with alt credit managers. For investors, these customized securitizations represent an investment in bank assets that they like, aligned with the banks' remaining positions and benefitting from the leverage implicit in bank equity. For the banks, the reduction of risk shows regulators a reduced need for equity capital, and access to market liquidity—albeit private market liquidity—at a cheaper cost of capital than an outright equity issuance.

The concept works well for both sides, and is again indicative of how the more complete specialty finance ecosystem can offer a wide range of beneficial relationships.

FINANCING MARKETPLACE LENDERS AND THE TECH-TRANSFORMED ECONOMY

A whole new set of players has emerged since 2008, presenting opportunities that can be new, but are sometimes old opportunities dressed in new clothes.

In an effort to make the loan business better, the marketplace lending sector is deploying a wide range of digital tools. Internet-first lending platforms have established beachheads in unsecured consumer lending (Lending Club and Marlette), student loans (SoFi and College Avenue), point-of-sale lending for e-commerce partners (Affirm) and small business lending (OnDeck, FundingCircle and Kabbage). In addition, legacy financial institutions and major consumer brands are contemplating whether their resources and expertise might position them well to enter the e-lending business.

These start-ups are much like the OpCo in the OpCo/PropCo model in that their goal is to originate loans, not to hold them on their balance sheets. Credit investors will ultimately own the loans. For the investor, the decision to purchase a loan from a marketplace lender is no different from the task of analyzing the risk on any other comparable loan.

But what if there is no comparable loan? The tech-transformed economy has begun approaching alt credit investors, in need of more than just capital for loans. A wide range of new assets are requiring financing.

The idea of a partnership between a professional asset manager and an asset-light business model has caught the attention of both Silicon Valley and Wall Street. Businesses that have traditionally required ownership of large asset portfolios—think hotels and taxis, for example—are realizing that the OpCo and the PropCo can be unbundled.

The relationship between the novel business and the alt credit investor began as a matter of necessity. Having seen the success of a few such relationships, however, entrepreneurs are intentionally reimagining businesses that previously required asset-heavy balance sheets, with the notion that the capital markets can own the assets.

We explore this notion further in a companion Perspective paper, Assets-as-a-Service.

CONCLUSION

The modern era of specialty finance evolved in parallel with the banking sector, its institutions stepping in to lend where banks were unwilling or unable. Specialty finance thrived by being nimble, adapting to changes in the financial ecosystem that ranged from the democratization of the capital markets, to the dawn of lending institutions captive to an operating partner, to the ABS revolution, and an era of financial overreach that ultimately required a series of government-led mop-up jobs.

The survivors in specialty finance are still adapting to the evolving environment. There are some constants, however. Looking to hard assets or consumer assets as collateral—a hallmark of specialty finance since its inception—has proved itself through many cyclical and secular changes. Assets—the "A" in ABS—provided the foundation for the decades-long success story that is securitization. Collateralized lending opportunities can be harder to analyze, requiring a complex analysis of underlying assets and structures. They are therefore available to a specialized set of investors. But those investors are rewarded with a rich range of investment opportunities, protected on the downside by stable asset values and often generating superior returns because these opportunities are either overlooked or considered out of reach by the broader market.

FOOTNOTES

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DISCLOSURE